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> Cornelia Woll

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CORNELIA WOLL

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Cornelia Woll is a researcher at the Center for International Studies and Research (CERI) at Sciences Po and leader of a junior research group at the Max Planck Institute for the Study of Societies in Cologne. Her research covers economic policy-making and financial regulation and she has notably published *Firm Interests: How Governments Shape Business Lobbying on Global Trade* (Ithaca, NY: Cornell University Press, 2008).

Cornelia Woll est chargée de recherche au Centre de recherche et d'études internationales (CERI) à Sciences Po et dirige un groupe de jeune chercheur au Max Planck Institute for the Study of Societies à Cologne. Ses recherches portent sur les politiques économiques et la réglementation financière. Elle est l'auteur du livre *Le lobbying à rebours : L'influence du politique sur la stratégie des grandes entreprises*, paru aux Presses de Sciences Po en 2011.

Contact: cornelia.woll@sciences-po.fr

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Abstract:

The highly politicized debate about the recent Alternative Investment Fund Manager (AIFM) Directive of the European Union led many observers to suspect an ideological battle between countries seeking to impose transnational regulation on financial service industries such as hedge funds and liberal market economies insisting on the benefits of market discipline in order to protect their financial centers. The battle that appeared to particularly pit France against the United Kingdom can thus be interpreted as an example of a regulatory paradigm shift in the aftermath of the crisis. This article cautions against such an ideas-centered account of financial regulation and points to the economic interests that drove the French and German agendas. However, contrary to the assumptions of traditional political economy approaches, national preferences were not simply defined by the aggregate of a country's economic interests. Rather, industry success in shaping government positions on alternative investment regulation crucially depended on how a given industry fit into the government's overarching geo-political agenda. By highlighting this feedback loop between government strategy and industry lobbying, the paper proposes a strategic analysis of financial regulation, as opposed to accounts that consider positions to be pre-determined by ideas or socio-economic structures.

Résumé :

La polémique autour de la directive européenne sur les fonds d'investissement alternatif (AIFM) est souvent citée comme exemple d'une bataille idéologique. D'un côté, on trouve les pays membre qui insistent sur une réglementation accrue des marchés financiers, en particulier la France, de l'autre côté, ceux qui souhaitent préserver le marché libre, notamment le Royaume Uni. Nous montrons les limites des récits qui s'intéressent uniquement aux paradigmes de la réglementation financière après la crise et insistons sur les intérêts économiques derrière les différentes positions. En revanche, les positions nationales ne doivent pas être comprises comme simple agrégat des positions de l'industrie financière d'un pays. Le succès de leur lobbying dépend en très grande partie de la compatibilité des demandes particulières avec la stratégie géopolitique du gouvernement. L'objectif de l'article est ainsi de tracer les boucles de rétroaction entre les stratégies des gouvernements et le lobbying de l'industrie financière d'un pays, afin de proposer une analyse stratégique de la négociation intergouvernementale.

Introduction[1]

Few regulatory issues in the aftermath of the financial crisis have garnered as much public attention as the regulation of hedge funds. Hedge funds polarize public opinion and divide policy-makers: to some they are speculators who compounded the downward spiral, whereas to others they are simply market participants who suffered from the crisis more than they contributed to it. As a consequence, the recent regulation of hedge funds in the European Union (EU) through the Alternative Investment Fund Managers (AIFM) directive adopted in November 2010 was one of the most politicized and controversial debates in EU financial regulation.

A superficial reading of the battle that most notably pitted France against the United Kingdom (UK) might center on overzealous governments driven by ideology and national interest. According to British observers, the AIFM directive was an attack by the French government and market place on the City of London. With almost 80% of the hedge fund industry based in the UK and only a very small portion in France, President Nicolas Sarkozy had little to lose and could demonstrate his will to rein in uncontrolled financial activities and fight against tax havens. The UK, on the other hand, sought to preserve the principal attraction of the City of London – light-touch regulation – to avoid curtailing investment opportunities and to prevent an exodus of alternative investment firms from the UK. According to many British observers, there was little need to tighten regulation.

Should one conclude that the AIFM directive arose from mere opportunism, whereby politicians exploited the financial crisis to advance a pro-regulatory agenda? Did ideologically driven governments seize on the turmoil to attack this suspicious industry, all the more because only the UK had considerable economic interests at stake? Inversely, what explains the regulation of hedge funds in 2010 if they are not directly linked to the financial crisis, as some argue?

This article counters accounts that center on ideological battles over financial regulation. By unpacking the positions of the French, British and German governments, I will demonstrate that each one defended the interests of its respective industries. These economic interests went far beyond hedge funds, as the directive covered quite a large spectrum of investment funds, including mutual funds, private equity and real estate funds. However, the links between industry and government positions are oftentimes surprising and do not neatly reflect either capitalist systems or a given comparative advantage. Most importantly, *which* industries were most successful in influencing government depended on how their demands fit into the government's agenda for financial regulation. This agenda, in turn, mainly hinged on a Franco-German alliance that formed during regulatory reform and transcended the single issue of hedge fund regulation.

Put more theoretically, neither ideology nor capitalist systems can fully explain the evolution of the AIFM negotiations. Rather the politics of international financial regulation arose from a mix of business lobbying and international alliances wherein success and failure depended on how the two fit together, rather than on given conditions prior to the regulatory initiative. This article thus proposes a strategic account of hedge fund regulation and counters those that consider positions to be pre-determined by ideas or socio-economic structures.

[1] Earlier versions of this paper have been presented at the network meeting on "Institutional Change in the Regulation of Financial Markets" organized by the Max Planck Institute for the Study of Societies in Cologne on 24-25 March 2011 and at the COST Ph.D. School on Financial Regulation in Paris on 9 May 2011. I would like all participants for the discussion and their helpful comments, in particular Rahul Prabhakar, Lucia Quaglia and Christine Trampusch. I am furthermore grateful to all interview partners who freely gave of their time, to Helene Naegele for excellent research assistance, and to the Max Planck Society, who kindly funded the research through an Otto-Hahn research group grant.

The empirical account draws on qualitative interviews with industry representatives and policy makers in Brussels and the member states between December 2009 and April 2011, as well as primary documents such as legislative and policy documents and industry briefs.[2] The remainder of the article divides into five parts. Section 2 discusses theoretical accounts of financial governance and hedge fund regulation in particular, and lays out the argument. Section 3 describes the history and context of hedge fund regulation prior to the EU's regulatory initiative. I then turn to the central elements of my argument to trace the evolution in negotiations. Section 4 discusses the lobbying efforts and industry stakes, within member states, that most actively influenced the discussion. Section 5 moves to the international level to explain the issue linkages and alliances involved. I then conclude by discussing how these two levels became linked and why they explain the final outcome of the negotiations, by showing how the lessons of this case study apply more generally to the study of business-government relations.

1. Explaining conflict over financial regulation

Financial regulation, like other areas of regulatory policy-making, is marked by interstate conflict. With growing market openness, financial service provision highlights the tensions between different regulatory approaches, as national markets increasingly interact with, and are exposed to one another. Theoretical work in international political economy and European politics has tried to determine the fault lines of this conflict and the direction that negotiations over new or harmonized regulatory regimes will most likely take.[3] Treading the dividing line between political economy accounts and social constructivist perspectives, one can distinguish between approaches that focus on the distribution of economic interests and those that insist on the importance of ideas and how these shape government preferences over international regulation. I will discuss both of these in turn before proposing a more dynamic argument that highlights how the defense of domestic economic interests depends on the geopolitical agenda governments pursue. This strategic account is related to recent historical institutionalist perspectives on international market regulation (Farell/Newman 2011), but specifically highlights governments' room for maneuver, rather than the importance of historical constraints.

Political-economy perspectives

Materialist accounts of financial regulation tend to consider the distribution of economic interests, the institutions aggregating such societal demands and the relative market size of a given country in order to understand what position the government will defend and to what extent it can impose its views in international negotiations (Frieden 1991; Frieden 1999). At the most basic level, countries that already have a flourishing hedge fund industry would be expected to oppose tighter regulation in order to keep investment firms from choosing more attractive (i.e. unregulated) locations. Inversely, countries without a sizeable industry coalition in favor of light regulation have electoral incentives to push for tighter regulation in order to comply with consumer demands or to respond to the general public's concern about the potentially negative effects of unregulated financial markets.

[2] Interviews included officials from the European Commission, members of the European Parliament, representatives from the member states' governments and regulatory authorities, industry associations and lobbyists representing the affected sectors, as well as a public official from the US Securities and Exchange Commission.

[3] I will leave aside the discussion of the most relevant level of political authority – international, national or transnational (see Helleiner/Pagliari 2011). All levels are linked in the case of hedge fund regulation, but the most important issue that needs explaining is the classic question of the nature and evolution of interstate bargaining.

A related approach focuses less on the pressure exerted by individual industries, or the absence thereof, but instead highlights the general political economic order that characterizes advanced industrial nations. This "varieties of capitalism" literature draws attention to the institutions supporting the development of national production systems and argues that governments will defend those policy regimes that protect the areas in which the country has gained a comparative institutional advantage (Crouch/Streeck 1997; Hall/Soskice 2001). The size of the countries' markets and their industry structure therefore provide clues about developments in international regulatory negotiations (Drezner 2007). Concerning financial regulation, analysis most often focuses on the difference between bank-based systems, where finance for the economy crucially depends on commercial bank lending, and market-based systems, where capital markets are key (Zysman 1983; Rajan/Zingales 2001).

According to both strands, we should expect different regulatory preferences from countries with a liberal market tradition, that will seek to protect their light regulatory approach, and countries with coordinated market economies or bank-based finance, that will be more concerned about commercial banks and the role of finance in the transformation of their industrial structure. From such a systemic perspective, Germany should be very supportive of hedge fund regulation, both in order to protect their commercial banks and savings banks from the competition of new financial intermediaries, and in order to shelter their small and medium-sized companies from short-termist sources of finances. Put differently, the political economy literature leads us to predict that liberal market economies will be pitted against countries with a more coordinated tradition and more regulated financial markets. In the context of European politics, Quaglia (2010) refers to these groups of countries as the market-making (i.e. liberal) and the market-shaping (i.e. pro-regulatory) coalitions. Moreover, this fault line should remain somewhat stable over time, as past decisions create institutional advantages for each model and will therefore be supported and defended by both private and public actors.

New regulatory paradigms

Rather than highlighting stability, others have drawn attention to the rapid change in international financial regulation and attribute this to the role of new pro-regulatory paradigms that gain momentum in the aftermath of crises. In studies of the role of national regulators and their interaction in transnational networks, several authors have pointed out that the increasingly technical nature of financial regulation fosters a cognitive convergence and shared understandings about the necessities of regulatory intervention (e.g. Slaughter 2004; Porter 2005). Inversely, the policy preferences of liberal market economies are also the result of socialization and interaction of liberal-minded economists, particularly in international institutions such as the International Monetary Fund (Chwieroth 2010). According to such constructivist perspectives, understanding change in financial regulation therefore requires studying the drivers of regulatory reform and how these elites were trained or exposed to networks of like-minded professionals (Abdelal 2007).

In the European context, the analysis of regulatory paradigms requires paying particular attention to the European Commission and other supranational institutions such as the European Parliament. Driven by an institutional self-interest to expand its mandate to sectors that were previously beyond its remit, the European Commission has turned out to be a key player in financial market integration (Posner 2009). In particular, the Commission has in the past been able to generate conceptual innovation that was conducive to rallying new coalitions around its proposals (Jabko 2006). Its role as a policy entrepreneur therefore crucially hinges on the way it uses the new paradigms to channel the interests of member states towards further market integration.

In her analysis of the political economy of alternative investment regulation, Quaglia (forthcoming) points to the importance of ideas in explaining the shift from opposition between liberal and regulated market economies towards an agreement on the AIFM directive in 2010. The effect of the crisis was to implicitly validate the market-shaping regulatory paradigm and to silence supporters of light-touch regulation.

A strategic account of government stances on financial regulation

Accounts focusing on the stability of political economic orders and analyses focusing on paradigmatic change offer important insights into the evolution of financial regulation. However, the first is ill equipped to explain changes in government preferences and pays insufficient attention to the conditions under which existing domestic interests can successfully influence or fail to influence their governments. The second approach, in turn, tends to ignore the conditions under which new ideas become "interesting" to governments and therefore viable in international negotiations.

In line with a historical institutionalist analysis of international market regulation, I argue that the distribution of economic interests at the domestic level is important but does not predetermine government stances. Instead, the timing and sequence of negotiations create feedback loops which can favor some domestic interests over others. As a consequence, "variation in states' preferences over existing institutional bargains will depend on which interest groups have succeeded in becoming embedded in the relevant regulatory decision-making structure," (Farell/Newman 2011: 620). My argument thus relates to Fioretos' (2010) account of international hedge fund regulation. Beginning with a discussion of the fault lines among capitalist systems, Fioretos shows how the US changed its position and ended up introducing direct regulation, because the sequence of events created favorable conditions for policy actors with a pro-regulation agenda.

By placing even greater emphasis on the degree of government agency, I will describe how the evolution in EU negotiations depended on the dynamic interplay between domestic interests and the geo-political strategies of the major governments. Contrary to accounts claiming that the French and German positions were determined by a simple pro-regulation paradigm, I will show that domestic interests pushed for and benefited from the stances defended by their governments. However, these economic interests did not determine government positions unilaterally. Rather, these industries were successful in lobbying their national governments because their demands neatly fit with the strategic alliance the French and German governments had decided to form to achieve a revision of the international financial architecture. As Woll (2008) has argued, lobbying influences the positions governments will take in international negotiations, but government ambitions for these negotiations also shape both the way in which interest groups voice their demands, and whether they will be successful. In the case of EU hedge fund regulation, we therefore need to simultaneously consider the domestic roots of the member state stances and their geopolitical alliances.

2. From exemption to transnational regulation

Hedge funds are investment vehicles that are notoriously difficult to define, but they generally refer to highly leveraged funds that are only accessible to wealthy or institutional investors who pay a performance fee to the fund's manager. Using a variety of investment methods, they tend to hold both long and short positions, where investment in supposedly overvalued securities is counterbalanced by investment in undervalued securities. Contrary to what the term suggests, hedge fund strategies should be considered as "leveraged speculation", which is quite the opposite of the traditional way the term "hedging" is used in finance (Edwards 1999: 189).

Hedge funds especially developed in countries where securities markets already played a central role, such as, most importantly, the US and Britain.[4] In both of these countries, the regulation of hedge funds happened through *indirect* regulation. Rather than imposing registration or disclosure requirements on the hedge funds themselves, regulation applied to the counterparties. These prime brokers, in most cases investment banks, lend the money that allows for the highly leveraged strategies of hedge funds. Regulators therefore argued that the disclosure requirement and leverage ratios imposed on counterparties were sufficient to control for systemic risks. In the US, hedge fund managers were explicitly exempt from oversight by the Securities and Exchange Commission (SEC) until recently, while British managers had to be accredited by the Financial Service Authority. In continental Europe, hedge funds were most often directly regulated through registration, disclosure and reporting requirements. In Germany, hedge funds, or more specifically the investment techniques they employed, were even prohibited until 2004. In comparison to the US and the UK, the French and German hedge fund sector remains negligible to date (see IOSCO 2009; see Fioretos 2010).

The recent move to tighten the regulation of hedge funds at the international, regional and national levels is clearly tied to collective efforts in the aftermath of the financial crisis. After two decades of simple guidelines and codes of conduct, members of the G20 declared at the London summit in April 2009 that they intended to strengthen financial regulation and to extend it to sectors that were previously not covered, including “for the first time, systematically important hedge funds” (G20 2009: 4). As we will see, EU regulation was closely linked to this declaration, as was the regulation that followed in the US, most notably through the Dodd-Frank Act .[5] It is therefore helpful to recall the history of comparative and international regulatory efforts, in order to put the EU AIFM Directive into perspective.

Resisting direct regulation

The public first became aware of the power of hedge funds in 1992, when a hedge fund run by George Soros speculated against the pound sterling and eventually forced Great Britain to devalue the pound and leave the European Exchange Rate Mechanism – an episode which earned George Soros the title of “the man who broke the Bank of England”. During the Asian financial crisis of 1997-8, hedge funds arguably contributed to spreading the contagion. In 1998, the collapse of Long Term Capital Management (LTCM), a hedge fund run by two Nobel Prize-winning economists, threatened to bring down Wall Street; a wide-ranging financial collapse was only averted after the US Federal Reserve Bank coordinated a $3.6 billion bailout.

At that time, regulators began to scrutinize the industry, which had displayed a spectacular growth from 140 funds in 1968 to approximately 3,000 funds in 1998, managing between $200 - $ 300 billion in capital, and approximately $ 800 billion to $ 1 trillion in total assets.[6] At the international level, a new body was created by the G7 nations in 1999 to oversee macro-prudential risks: the Financial Stability Forum (FSF). The FSF contained a working group on highly leveraged institutions that immediately began investigating the risks associated with hedge funds (Financial Stability Forum 2000). In the US, the President charged a working group composed of the heads of the Treasury, the Federal Reserve Bank, the SEC and the

[4] The fund itself is a legal entity separate from its manager and can be domiciled in another country. Most often hedge funds are registered in offshore financial centers, which attract funds through tax exemptions or low regulatory requirements.

[5] See in particular Titel IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act. H.R. 4173. Vol. Pub.L. 111-203, 21 July 2010.

[6] Compare this to the asset sizes of US commercial banks ($ 4,1 trillion), mutual funds ($5 trillion), private pension funds ($4,3 trillion), state and local retirement funds ($2,3 trillion) and insurance companies ($3,7 trillion). All figures are from the President's Working Group on Financial Markets, 1999: “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management,” Report, page 1-2, available at www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

Commodity Futures Trading Commission (CFTC) to investigate the failure of LTCM and lessons learned (President's Working Group on Financial Markets 1999). Both investigations led to a series of recommendations, but affirmed that the locus of responsibility lay with national regulatory authorities, particularly with regard to improving counterparty risk management, and especially in matters concerning leveraging. In other words, the reports rejected the call by some more critical countries to impose transnational regulation and reaffirmed an indirect model of hedge fund regulation that focused on the prime brokers providing the hedge funds with funding (see Fioretos 2010: 708-709). While it kept responsibility with national regulators, the President's Working Group nonetheless advocated that the SEC work with its counterparts within the International Organization of Securities Commissions (IOSCO) to develop standards for hedge fund behavior.

Codes of conduct

At the national level, an attempt by the SEC to increase its oversight administratively through a change in the interpretation of the hedge fund exemption was rejected in court in 2006. In the UK, no significant regulatory was taken action either. Both countries remained committed to indirect regulation and followed up on their vague commitments to international coordination through the working groups of the FSF and IOSCO.

France and Germany, by contrast, both favored a direct regulation approach. In both countries, the 1990s and early 2000s were a period of significant financial market reform towards deregulation and the liberalization of financial services (Lütz 2000; Deeg 2005; O'Sullivan 2007). The decision to move from a traditional bank-based model to more diverse financial markets open to different investment vehicles came with distinct legal restrictions on these funds. Moreover, there was considerable political debate in both countries about the risks associated with open capital markets. In France, discussions most notably focused on the issue of a Tobin tax, which was to be levied on financial transactions. In Germany, the role of a British hedge fund in a battle to take over Deutsch Börse and the London Stock Exchange prompted the leader of the Social Democratic Party (SPD), Franz Müntefering, to refer to hedge funds and private equity as "locusts". The intense debate that followed with regard to the long-term responsibilities of investors and the negative consequences of short-term finances deeply resonated with the German public (Gumbel 2005). With French backing, the newly elected Chancelor, Angela Merkel, vowed to push for a tighter regulatory regime for hedge funds and made this a central issue of the G8 summit Germany chaired in 2007 in Heiligendamm.

These public debates, coupled with continued scrutiny from the consultative working groups at the FSF and IOSCO put pressure on hedge funds. Simultaneously, the European Central Bank became involved in the issue of systemic risks posed by hedge funds and the European Union began working on two directives that directly touched on the operation of hedge funds: a new directive on investor protection, the Markets for Financial Instruments Directive (MiFID), and a revision of a directive on collective investments schemes such as mutual funds – the directive for Undertakings for Collective Investment in Transferable Securities (UCITS) – the original version of which had been adopted in 1985.

Still, both the UK within Europe and the US at the international level resisted the calls for direct regulation. Both the FSF and IOSCO working groups were tasked with updating of their earlier recommendations in 2007, and the US government reconvened the President's Working Group. The President's Working Group underlined that "the current regulatory structure is working well" and that market discipline was more efficient that public authority in regulating the hedge fund market (President's Working Group on Financial Markets 2007: 1). In the EU, members of the European Parliament pressed for tighter regulation of hedge funds and private equity, most notably through the Rasmussen report and the Lehne report in 2008. However, Charlie Mc Creevy, the Irish Internal Market Commissioner, was concerned about the consequences of regulation for the investment industries and repeatedly declared that hedge funds would not be regulated by the EU (see Lutton 2008).

With the resistance of the US and the UK, the momentum was insufficient for more than a series of principles, guidelines, and recommendations, issued by both IOSCO and the FSF (cf. IOSCO 2009: p.39). The indirect supervisory approach thus remained in place. However, both public authorities and industry in the US and the UK moved to set up a credible self-governance regime, in order to avoid further regulation. The US Managed Funds Association (MFA) developed an industry code of conduct and the President's Working Group created two working groups charged with developing best practices. In Britain, industry created a Hedge Fund Working Group (HFWG) in order to develop an industry-based code and the London-based Alternative Investment Management Association (AIMA) also issued a series of recommendations (IOSCO 2009: 40; Fioretos 2010). Until the end of 2008, not much seemed to threaten this self-governance regime set up to support indirect regulation.

Direct regulation

And yet, the financial crisis that unfolded in the fall of 2008 led to a new sense of urgency and created opportunities for more encompassing reforms. Members of the G20 publically acknowledged the limits of the self-governance regime in international finance, and at the London Summit in April 2009, they declared their goal of extending regulation to previously exempted sectors, in particular hedge funds. In order to do so, they insisted that hedge funds or their managers had to be registered with national authorities, and they decided to grant the responsibility of monitoring systemic risks associated with hedge funds to the successor of the FSF, the Financial Stabilities Board (G20 2009). The G20 agenda mirrored the changed US position on financial regulation. In 2009, a bill passed by the House Financial Services Committee in November made registration of hedge fund managers mandatory and gave states the authority to oversee smaller hedge funds, leaving the SEC in charge of larger investment funds (Scannell 2009).[7] Shortly after, this Private Fund Investment Advisers Registration Act of 2009 became Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act. By imposing registration and reporting requirements, the new legislation effectively closed the loophole which hedge funds had previously benefited from and which the SEC had unsuccessfully tried to change through an administrative rule-making procedure in 2006.

In Europe, and almost in parallel with the London Summit of the G20, the European Commission published a proposal to regulate hedge funds and private equity firms through registration and disclosure requirements on all funds previously left outside of the UCITS directive of 1985. Despite the preceding consultation the Commission had launched and despite the staunch opposition of a substantial part of the industry to these regulatory ambitions, the proposal followed up on the Rasmussen and Lehne reports of 2008 and insisted on the need for a harmonized direct regulatory regime to be applyied across Europe (European Commission 2009a; European Commission 2009b). Specifically, the Commission proposed that all alternative investment fund managers operating in the European market be subject to authorization and oversight according to commonly defined principals. In exchange, managers authorized to operate in one of the member states wiould obtain a European passport enabling them to operate anywhere in the European market without having to apply for additional authorization in the respective countries. Significantly, this passport would also be available for managers of funds domiciled in countries outside the EU.

The proposal, which was produced in record time according to most observers, was met with outcry from all sides. The investment industry and representatives from liberal market economies such as the UK and Ireland complained about the costly regulatory requirements

[7] The threshold is defined as hedge funds that manage less than $100 million.

and sometimes even entirely rejected the proposal. Observers from pro-regulation countries were concerned about the scope of the directive and its implications for bringing in funds offshore financial centers into the European market. In the intensive negotiations that followed in the European Council and Parliament, substantial revisions were introduced and the discussion came close to entirely breaking down in several instances.

We will analyze the different positions and study the evolution of negotiations in the following sections. However, it should already be clear that the EU directive was more than just a consequence of the financial crisis. The directive proposal even clearly states that "AIFM were not the causes of the crisis" (European Commission 2009b: 3). Indeed, hedge funds themselves suffered considerably: almost 2,000 hedge funds went bankrupt and about $ 530 billion of their assets were destroyed from 2008-2010 (Aglietta 2010). Should one therefore conclude that the financial crisis only provided a welcome opportunity to advance the pro-regulatory ideology of France, Germany and the European Commission?

3. Economic interests in European alternative investment

Understanding the stakes and the evolution in regulatory efforts requires studying the interests and coalitions within the EU that led to the current regulatory framework. We will therefore examine in which countries the affected industries were located and analyze their lobbying strategies.

Stakeholders within and beyond the hedge fund industry

As highlighted by different regulatory approaches highlighted, the hedge fund industry comprises several stakeholders: investors; the fund itself; the managers/advisors of the fund and the prime broker/dealers, who provide lending to support leverage and facilitate short selling, but also provide clearing and settlement of trades, and custodial services. In some cases, prime brokers can outsource services to separate custodians. Similarly, hedge fund managers can outsource administrative functions such as accounting or risk analysis to fund administrators. All in all, this implies that a considerable number of financial service activities are linked to the hedge fund industry (see Hardie/MacKenzie 2007).

The United States is the largest center for hedge fund management, accounting for 68% of the total industry in late 2009, followed by Europe with 23% and Asia with 6%. Within Europe, 76% were managed out of London. Other important locations include Sweden (5%), Switzerland (4%), France (2%) and the Netherlands (2%). The funds themselves are predominately domiciled in offshore financial centers: the Cayman Islands are the most popular with 39%, followed by Delaware (US) with 27%, the British Virgin Islands with 7% and Bermuda with 5% of funds. Another 5% of global hedge funds are registered in the EU, primarily in Ireland and Luxembourg.

The attraction of the UK for hedge fund management is linked to its concentration of related services. With approximately half of the European investment banking activity conducted through London, it is a central location for prime brokerage, but also administration, custody and auditing. However, among the largest hedge fund prime brokers, one can also find Deutsche Bank (6% share of the brokerage industry), and among hedge fund administrators the French CACEIS Investor Services (6%) and the Fortis Prime Fund Solution (6%), which is currently owned by the French bank BNP Paribas (all figures from International Financial Services London 2010). Ireland is another important location for hedge fund administration.

Finally, many hedge funds in Europe have recently launched UCITS III compliant fund vehicles, which they are allowed to distribute throughout Europe to retail clients. In other words, hedge funds not only offer institutional investors products but have adapted to the regulated retail investor market in order to provide funds which qualify for the European UCITS passport. UCITS services under hedge fund management grew by an impressive 50% in 2009, particularly in the UK, but also in France and Luxembourg (International Financial Services London 2010). This development is significant, because it implies that hedge funds are beginning to enter into competition with the traditional mutual fund industry, which is regulated since 1985 under the UCITS directive that prohibits both leveraging and short-selling. Second only to the US at the global level, France is a prime location of UCITS funds both in terms of management and domicile. 23% of European UCITS funds are managed in France, followed by Germany (20,1%) and the UK (15,8%). In terms of domicile, France comes in second with 20,3% of funds, after Luxembourg (26,2%) (Association française de la gestion financière 2010).

However, the AIFM directive is not just an issue for the hedge fund industry and its competitors. Indeed, one of the most central and most controversial decisions of the initial proposal was to address hedge funds through a directive covering *all* investment funds that were previously left outside the realm of EU legislation. The definition of the scope of the AIFM directive is therefore a negative definition, seeking to cover "the management and administration of any non-UCITS in the European Union" (European Commission 2009b: 6). While pension funds and non-pooled investment such as sovereign wealth funds were excluded, private equity and venture capital funds, real estate funds, commodity funds, infrastructure funds and other types of institutional funds wiould have to comply with the AIFM provisions. The private equity industry was especially concerned about the directive. Private equity firms, which provide funding for companies that are not publically traded on stock exchanges, are mainly managed in the UK (12,4%), but also in France (4,7%), Germany (3,3%) and Sweden (1,7%) (TheCityUK Research Center 2010). In Germany, real estate funds furthermore play an important role.

It is thus incorrect to state that only the UK had considerable economic interests at stake because it is home to almost 80% of the hedge fund industry. To be sure, the City of London had a stake in almost all aspects of the hedge fund industry, as well as all other affected investment funds. But France and Sweden also have important hedge fund activities, and all the more so if related services such as prime brokerage are included. As preferred locations for the registration of funds within Europe, Ireland and Luxembourg furthermore had an interest in keeping the hedge fund industry flourishing. If one includes private equity and other investment vehicles, the spread of economic stakeholders becomes even broader. The industries and firms that we would expect to lobby in support of light-touch regulation can thus been found in the UK, France and Germany. Further support would be likely from Sweden, Luxembourg and Ireland, if one considers industry stakes only.

However, what is mostly overlooked is that a specific branch of the investment industry was quite concerned about the growth in the unregulated investment sector: collective investment funds falling under UCITS. These funds had begun to enter into the hedge funds market, where they encountered competition from hedge funds offering UCITS-compliant products. This implied that UCITS funds had a strong interest in assuring that this competition happened within the UCITS regulatory framework, wherein all market players would bear the same costs. UCITS funds are predominately located in France. In the following, I will argue that it is the political influence of the UCITS industry that led to the French government's refusal to accept a European passport for third country funds.

Lobbying strategies

Many members of the investment industry only realized how imminent EU regulation was when they read the first proposal of the European Commission in April 2009. Investment funds had become used to being unregulated and only paid partial attention to the consultation procedure the Commission had launched between December 2008 and January

2009. For the private equity industry in particular, the draft was a cold shower they did not expect, because they had done their utmost to insist on being exempted from investment regulation (interview with a business representative, Brussels, 4 March 2011). For a long-time, private equity groups felt that they were "legitimately not regulated", because they provided financing to small and medium-size companies; in the case of venture capital "they were the nice guys" helping firms focusing on technological innovation, even in risky areas (interviews with a business representative, Paris, 10 February 2011; European Commission, 10 March 2011).

In the period following the publication of the proposal, the CEOs of investment funds relied on their well-established ties with national politicians and sometimes even insisted on their most basic desire: to be exempt from the pending regulation. This initial lobbying period was somewhat awkward and unsuccessful at the European level. According to one representative,

> [Within the EU] if you fail to convince at the technical and technocratic level, it does not help you to be friends with the finance minister of your country or to be able to stand on your head. […] Knowledge of the procedure is very important. [The investment managers], taken individually, may be falcons, but taken together, they behaved like a bunch of frightened sparrows trying to stop a steam roller (interview, Brussels, 4 March 2011).

It took a learning curve for investment firms to get organized and begin to contribute constructively to the negotiations in order to limit the negative impact on their sector of activity. Eventually, most business associations ended up endorsing the general ambition of the proposal, but suggested substantial modifications to the heart of the text. The private equity industry's lobbying strategy is quite illustrative of this development: its European association EVCA withdrew an initial policy statement in which it had spoken out entirely against the proposal, and began to support the idea of European harmonization in order to be able to shape the details of the directive (interview, European Commission, Brussels, 10 March 2011).

Simultaneously, the national associations lobbied their ministries, regulators and national Members of the European Parliament (MEPs) to gain support for the common position. British industry representatives from all concerned domains furthermore coordinated their lobbying in both London and Brussels and deployed a tremendous effort to shift the details of the draft as well as the general attitude in the European Parliament but also the Commission towards an approach favoring light-touch regulation.

Still, the British industry was initially not very adept at taking collective action, because they had never been the objects of substantial regulatory efforts. Firms could chose to be represented by AIMA, by the Association of Investment Companies (AIC) or the Investment Management Association (IMA), but membership is not obligatory, contrary to France, for example. A 2009 parliamentary report highlighted that the Hedge Fund Standards Board, which collectively defines industry standards through AIMA's voluntary code of conduct, had only 34 members out of 400 to 450 firms (House of Commons 2009: 128). To ward off what was perceived to be a European attack on the British regulatory model, Her Majesty's Treasury, the FSA and industry mobilized in several working groups. As one public official explained,

> Treasury held town hall meetings with hedge fund managers. You had guys worth hundreds of millions sitting on the floor because there was not enough space. They thought it would all be fine, that there was no way [the regulation] could happen. They would just shout or yell when we told them otherwise (cited in Prabhakar 2011: 23).

In contrast to these big investment funds, which only grasped the importance and functioning of the European policy-making process over the course of the negotiations in 2009 and 2010, the UCITS industry had already been playing the game since 1985. Having been active during several revisions of the UCITS directive, they monitored developments in Brussels much more closely and already had well-established ties at the national level with public officials working on EU regulation, as well as in Brussels. This difference in EU public affairs experience would turn out to matter immensely, since the UCITS industry was able to make a very forceful case against some of the provisions of the AIFM directive early on (interview with a business representative, Frankfurt A.M., 21 February 2011). According to one observer, the relationship between these funds and the French finance ministry is the only plausible reason that can explain the rigid position France defended throughout the negotiations. He argued,

> [French finance minister] Lagarde and [other French representatives] took issue with third country passports, even though it was not the position of the banking and private equity industry, or of French investors. But a small portion of the UCITS industry ended up being in competition with hedge funds and was afraid that these would be exempted from the regulatory costs weighing on the UCITS industry. They therefore said 'If they get a passport, we are dead' and the government ran with it all the way (interview with a business representative, Brussels, 4 March 2011).

Indeed, a French public official declared himself to be puzzled by his government's position, since it "[did] not reflect the interests of the French investment industry, which looks much more similar to the British industry than one would be led to believe," (interview, Paris, 25 November 2009).

While the French government argued that its position was congruent with its battle against tax havens, which often host alternative investment funds, several observers doubt the validity of this argument. According to proponents of the proposal, including French MEPs like Jean-Paul Gauzès, it is more efficient to impose constraints on tax havens with a passport system than without one (interview, Paris, 19 May 2011).

Why was a small portion of the French industry so efficient in its lobbying that it outweighed all other business interests on these issues and almost brought the AIFM negotiations to a stand-still? In the following section, I will argue that we need to consider the member states' strategic alliances on financial regulation more generally, to understand which demands translated into the ones the member states defended at the EU level.

4. Geopolitical stakes and the Franco-German alliance

Most notably, a Franco-German alliance on regulatory reform in international finance turned out to be crucial to the evolution in AIFM negotiations. The joint interest in hedge fund regulation began as early as 2007, at the G8 summit in Heiligendamm, but at the time proponents of a more regulatory approach had little traction. As the financial crisis unraveled, both French and German policy-makers realized that they should seize the opportunity to advance their respective objectives.

Germany had remained suspicious of hedge funds since it allowed their operation in 2004 and wished to tightly regulate them. The experience of the Deutsche Börse take-over and a general public mistrust towards alternative investment funds such as private equity, turned hedge funds into fertile ground for political activism in Germany (cf Milne 2008). French President Nicolas Sarkozy, in turn, sought to capitalize on the financial crisis to become the founding father of a new financial architecture he intended to push under the French presidency of the EU in the second half of 2008, and later under the French presidency of the G20 from 2010 to 2011, just months before his upcoming election. Facing countries with a more light-touch tradition on financial regulation, the two governments made a pact to support each other in order to defend a pro-regulatory agenda against the Anglo-Saxon laissez-faire tradition. This general agreement fundamentally shaped alternative investment negotiations. According to a French government representative:

> Ten years ago, we were like the Germans, but we have liberalized a lot recently […]. But on [alternative investment] we do not argue against the German position for political reasons, which come from the highest level. President Sarkozy has asked us to support Germany all the way," (interview, Paris, 25 November 2009).

The first person to succumb to the pressure of the Franco-German alliance was Internal Market Commissioner Charlie McCreevy. Initially, he had publicly declared that hedge funds would not be regulated under his leadership, and allegedly signaled to his staff that anybody working on such a proposal would be fired (interview cited in Prabhakar 2011: 110). Yet as Commission President José Manuel Barroso faced re-election in 2009, the French and German governments indicated that progress on a hedge fund directive was important to obtaining their support. With similar signals from the European Parliament, Barroso insisted that a proposal be ready as soon as April 2009. As a result of these political imperatives, a proposal was produced in record time and without much exchange with national officials after the official consultation in January 2009. The inspiration for much of the original text came from existing European directives, in particular UCITS and MiFID, in the interest of saving time. This explains why even supporters of the regulation were disgruntled when they read the first draft (interview, Paris, 10 December 2009). Arguing that British mistrust was partly unjustified, a French official underscored that,"[the British were] convinced that France [was] behind this directive, but I can assure you that it came from DG Market, maybe with some help from the Germans," (interview, Paris, 25 November 2009).

Most importantly, German government representatives were concerned about the effects of alternative investment on the company structure and corporate governance regime of German firms. They therefore wanted the most comprehensive regulation possible to ensure that any type of investment would not threaten co-decision procedures and worker rights. France might have not been behind hedge fund regulation in general, but it did have strong opinions when it came to the details. A European solution was advantageous, because the UCITS blueprint that was copied into the AIFM proposal reflected many of the particularities of the French market. However, the French were very concerned about the third country passport, the negative effects of which had been highlighted by their UCITS industry. Throughout the eighteen months of negotiations and the 18 trialogues between the Commission, the Council and the European Parliament, this issue turned into the most important bone of contention. French showed no intention of opening the European market to offshore funds – a position that effectively made the proposal inacceptable to the British industry.

After repeated stalemates in July, September and October 2010, it became clear that France was isolated in its opposition to the third country passport in the Council. And yet, in the run-up to an Ecofin Council, the treasury secretary who was supposed to represent Germany got a call from the finance minister, Wolfgang Schäuble, who insisted "I promised Christine Lagarde that you will not isolate her," (interview, Brussels, 4 March 2011). In spite of their doubts about the substance of the French position, the Germans thus afforded France some extra time to propose a last compromise, which suggested that the new European Securities Market Authority (ESMA) should be charged with the licensing of third-country fund access to the EU market (EurActiv 2010a). The British refused to grant such powers to a European authority and even US Treasury Secretary Timothy Geithner intervened by writing to French Finance Minister Christine Lagarde to warn about the consequences of French protectionism.

With strong opposition from the UK and German support waning, the French finally decided to accept a compromise that allowed third-country access and left it up to national regulators to grant third-country funds access. In exchange, the UK accepted to delay access for third-country funds until 2015. Moreover, ESMA was charged with drawing up the requirements these funds would have to fulfill, and it is expected to settle disputes between national regulators if they disagree on the elegibility of a given fund (EurActiv 2010c).

This final agreement was reached on 26 October 2010, leading to adoption by the European Parliament on 11 November, just in time to present the new EU regulatory framework at the G20 meeting in Seoul on 12 November, before it was approved by the Council of Ministers on 17 November. While member states concentrated on national fault lines, the European Parliament moved to pass substantial changes to the initial proposal, tabling a total of 1690 amendments! This unusually high number was necessary, according to MEP and directive rapporteur Jean-Paul Gauzès, in order to build support from both camps: those who insisted on the need for more control and those who pointed to the attendant costs for affected industries (interview, Paris, 19 May 2011). To bring the hastily written draft in line with the realities of different alternative investment funds, he held 198 meetings with industry representatives (Serrouya 2010). The European Commission official following the directive admits he stopped counting after the number of meetings reached 150 (interview, Brussels, March 2011).

The directive came into force in January 2011. From this date, each Member States has two years to transpose the directive into national law, with the assistance of the ESMA, which will provide advice on the most appropriate implementation measures for the 210 pages of the directive. This means that the directive will only become effective in practice in January 2013. The passport for third country funds and managers will become available after an additional two-year transition period, in January 2015.

Conclusion

The AIFM directive was one of the EU's most disputed post-crisis regulations. Most importantly, it pitched France against the United Kingdom. As with most political compromises, none of the negotiators obtained what they initially sought. While the United Kingdom had to accept that alternative investment would be regulated at the supranational level, France did not succeed in excluding offshore funds from the European market. Although the British press relentlessly bashed French protectionism and the EU's unjustified regulatory push, even *The Economist* defended the proposal as a useful attempt to simplify and harmonize the existing regulatory frameworks (Anonymous 2010). Indeed, the fund industry in London now has the advantage of providing a one-stop regulatory shop for all operations in the European market.

France in turn obtained a regulatory framework for institutional investment that looks quite similar to the one it initially helped to shape for the retail mutual funds market. However, notwithstanding the insistence of the French government, the origin of funds is not an issue, as long as they comply with the regulatory requirements imposed on hedge fund managers.

For the German government, any encompassing regulation is satisfactory, as they have the least amount of their industry's economic interests at stake. Concerned with the preservation of the German corporate model, German MEPs most notably affected issues such as asset stripping, which was a central issue for private equity firms. The final agreement now limits the selling off of capital – or asset stripping – in the years after a company is bought by a private equity investor. Regulating asset stripping reduces the attractiveness for private equity firms to buy a company in order to sell off its assets and make a quick profit (EurActiv 2010b).

In sum, despite heated political debates, the hedge fund regulation resembles other initiatives to harmonize operations in the European market. To be sure, the most important issue will be the implementation of the ambitious project. One will have to judge in several years whether the framework merely opened a pan-European market or actually provided additional control mechanisms over alternative investment that can be effectively used.

What this case study has tried to demonstrate is the strategic nature of business-government interactions and intergovernmental negotiations in the EU. It is insufficient to state that countries will defend national advantages and existing industry structures, or that paradigmatic change can trigger important reorientations in the regulatory agenda. It is true that each government is very concerned with its industry interests and tries to make sure that policy proposals do not damage vital parts of their economies. Likewise, new economic ideas and the reorientation of public intervention after the crisis are also important in understanding the momentum of political activism. However, one needs to ask *which* economic interests a governments will ultimately defend and *when* paradigm shifts lead to political action.

The answer given in this study is that it depends on the strategic constellation of actors at both levels: domestically and internationally. Domestically, a specific portion of the French industry skillfully lobbied the French government from a very early stage to protect the competitive conditions in its sector. This lobbying turned out to be very consequential for most of the negotiations, because it allowed the French government to build and maintain an alliance with Germany, which was very eager to advance hedge fund regulation. The feedback loops between the initial interests and the strategic advantages these provided are thus context-specific and can evolve over the course of negotiations, as historical institutionalism specifies. However, this evolution should not be reduced to a simple paradigm shift, a new pro-regulatory paradigm, or an ideological battle between Paris and the City of London.

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